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The new enforcers

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One of the biggest legacies of the Clinton administration will be its revival of a more aggressive antitrust policy

IN MARCH, when the Nasdaq stockmarket stumbled, it became clear that the company with the biggest market capitalisation in the world, and a symbol of America's dynamic "new economy", Microsoft, had met a competitor it could not crush, legally or otherwise: the Department of Justice (DOJ). Microsoft's defeat in court may not have been the only reason that nervousness set in over the prospects for tech stocks. But it certainly focused the attention of America's most nervous class, its investors, on a risk that many hoped had been laid to rest during the Reagan administration: antitrust.

A new expression seeped into Wall Street's vocabulary, the "Klein spread", named after Joel Klein, head of the DOJ's antitrust division, who is leaving his post shortly. Mr Klein is one of the few members of the Clinton administration who can honestly say, "I have done what I set out to do." The Klein spread reflects the discount in a company's shares based on possible antitrust problems. Companies affected include WorldCom and Sprint, whose planned merger was blocked earlier this year. Decisions by the Federal Trade Commission (FTC), America's other federal antitrust agency, to block the merger of Staples and Office Depot and to take a long hard look at the combination of AOL and Time Warner have also upset investors.

These high-profile cases, though, are mere punctuation marks in a far bigger story. How pervasive antitrust action has become is shown in a report by the FTC and DOJ about their activities in 1999. The DOJ slammed companies in the businesses of billboards, school textbooks, rubbish collection, wireless telephony, parking lots, milk, radio stations, paper coatings, asphalt and concrete production, software, health care, grain purchases, banking and petroleum-drilling fluids. Not to be outdone, the FTC hit supermarket chains, cement producers, petrol companies, funeral parlours, medical-equipment makers, lead smelters, drug companies, pipelines and the chemical outfits producing gloss for kitchen-floor wax and anti-knock additive for petrol.

In the past few weeks alone, an appeal court increased the jail sentences for two men who played a role in a price-fixing scandal at Archer Daniels Midland; Wells Fargo, a large bank, agreed to

divest branches in four states as a condition of a merger; the big American options exchanges were sued for refraining from trading the same contract in several different places; the record industry signed a consent decree barring firms from pushing for including minimum prices in advertisements for compact discs; and a merger was blocked between two companies with a large share of the business of producing patterns for home-sewing.

Nor does it stop there. The FTC is about to announce a $100m penalty on Mylan Laboratories, a drug company, for cornering the market for the active ingredient of a common anti-depressant. A radio operator has agreed to sell 99 stations in order to complete a merger. In Florida, two hospitals paid $500,000 in fines for co-operating too closely on a partnership. And manoeuvring continues in the lawsuits against MasterCard and Visa and, of course, Microsoft.

The urge to merge

As for mergers, since the end of 1997, the DOJ has blocked big ones in defence (Lockheed Martin and Northrop Grumman), aluminium (Reynolds and Alcoa) and telecoms (WorldCom and Sprint, and numerous cellular deals). It has tried to block a merger between two airlines (Continental and Northwest Airlines) and prosecuted another, American, for predatory pricing. The FTC has stopped mergers in drug distribution (one involving McKesson, the other Cardinal Health), supermarkets (Kroger with Winn-Dixie, Pathmark with Royal Ahold), bookselling (Barnes & Noble with Ingram), video rentals (Hollywood Entertainment and Blockbuster), helicopter making (Bell with Boeing), industrial gases (British Oxygen's acquisition by Air Liquide and Air Products), drugs (Abbot with Alza) and cement (Lafarge with Blue Circle).

Those mergers that do get through are often altered. JDS Uniphase was allowed to buy E-Tek only on condition that rights to buy sophisticated fibre-optic components would be surrendered. Banks, rubbish collectors and telephone companies have been allowed to complete acquisitions only if they make divestitures. Intel had to share chip technology acquired from Digital Equipment with Advanced Micro Devices and Samsung. Roche, a drug maker, was allowed to buy Corange only after agreeing to reveal research on sophisticated heart medication. As a condition of their merger to form Diageo, Grand Metropolitan and Guinness were required to sell Dewar's Scotch and Bombay gin.

Straight and narrow

Taken individually, most such cases may seem tediously narrow, of interest only to those directly affected. Perhaps because of this, the expanding reach of antitrust in America has received little attention. It helps that Mr Klein and his counterpart at the FTC, Robert Pitofsky, have been deliberately low-key in talking about their activities, claiming that they are modest and in the mainstream of legal thought and economics. They concede that they have been more interventionist than the laisser-faireideologues of the Reagan years, but they say they are nothing like the trust-busting zealots of the 1960s who saw evil in every big company or merger. It is inconceivable today, says Mr Pitofsky, that mergers of companies with insignificant market share would be challenged, which was common in the heyday of antitrust; but it is equally inconceivable that 24 airline mergers would be permitted without a challenge, as they were in the 1980s.

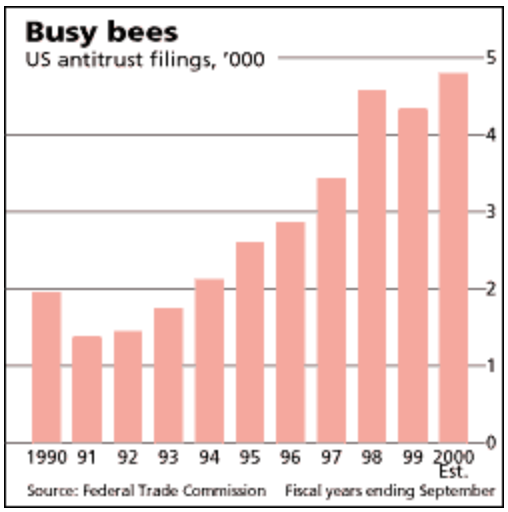
To prove their moderation, the trustbusters point out that the percentage of mergers to which they give more than an initial review is 2% and falling. But this is misleading. The number of mergers each year has risen to almost 5,000, over twice as many as a decade ago. Lots of mergers now get an initial review even though nobody believes they pose any threat to competition. In 1976 Congress passed a law requiring every merger worth more than $15m to be submitted for review to the FTC and DOJ, a number chosen to catch only the 150 largest deals. By 1999, some 70% of the mergers submitted were worth less than $100m, a value many investment banks would consider too small to justify a public offering of their shares.

Other figures point more clearly to a resurgence in antitrust activity. Criminal fines levied by the DOJ have risen from $27m in 1996 to $1.1 billion in 1999. The staff at the DOJ's antitrust arm, slashed from 1,000 to 500 during the Reagan administration, has now crept back up to over 800—and this understates the true increase, because the department is increasingly outsourcing big cases to private law firms. More mergers have been blocked in the past three years than during the entire Reagan administration. The Mylan fine is five times larger than anything previously imposed by the FTC. The three-year jail term for one executive at Archer Daniels Midland was another record. Criminal-contempt fines, long absent from antitrust suits, were revived in the petroleum-fluids case.

When America first passed the Sherman antitrust act in 1890, it was unique in the world. Now, according to a report prepared by the DOJ, more than 80 countries have antitrust legislation on their books. This has helped American officials to extend their reach abroad. Bilateral agreements on enforcement have been signed with Brazil, Canada, the European Union, Japan and, this July, Mexico. Co-operation with the EU's competition authorities is particularly close, though the risk of conflict remains (see article). In a recent valedictory speech, Mr Klein called for the creation of a new agency to co-ordinate international antitrust activity; the EU has suggested expanding the scope of the World Trade Organisation to include competition policy.

A decade ago, American antitrust efforts looked almost exclusively at American companies and transactions. This has changed dramatically, as American trust-busters have taken on many international cartels. Six European executives are behind bars in America for conspiring to fix the vitamins market. Executives at De Beers face an outstanding warrant from a 1994 cartel investigation that has resulted in its key executives, in effect, being banned from the country. More than 90 grand juries are hearing evidence in cartel cases, a third of them with international scope. James Griffin, head of the Justice Department's cartel-enforcement effort, says his department is negotiating one plea bargain a month with people wishing to expose price-fixing rings.

The Clinton trust-busters not only differentiate themselves from the Reagan years in their activism. They have also made a subtle change from the administration of George Bush Sr, when antitrust enforcement mostly took the form of private agreements between regulators and companies. The administration has overtly sought to make law by pushing cases into court. Companies that try to cut a deal are finding it much harder to get a yes. Concessions were offered and rejected by Staples and Office Depot, and by both McKesson and Cardinal Health, among others, says Mr Pitofsky. Mr Klein boasts of his department's willingness to take huge cases, such as Microsoft, Visa/MasterCard and American Airlines, to court. "Go back decades," he says. "You can't find a case of that magnitude."



In business we don't trust

According to Mr Klein, the recent surge of antitrust activity is mainly a response to four trends: deregulation, a merger wave, globalisation and technological change. Not long ago, large state and federal bureaucracies set prices for utilities providing electricity, telephone lines and even airline flights. The number of radio and television stations any single company could own was limited. Such controls have all gone, leaving only market forces. That means it is up to the antitrust authorities, Mr Klein argues, to ensure that markets are sufficiently competitive.

The huge volume of mergers has been more remarked on. But, as Mr Klein puts it, it is still "an

order-of-magnitude shift ill-appreciated as to its consequences." And since many of these deals are global in scale, that brings further complexity and, potentially, dangers.

Mr Klein also lays great emphasis on the potential for new technology to create global monopolies. In particular, "network effects" may make it hard for rivals to enter an industry already dominated by an incumbent with an established network of users. Network effects allowed Microsoft to create the "applications barrier to entry" that was a big element in the case against it. But they exist in numerous other markets as well. The antitrust authorities are particularly concerned to ensure that newly created business-to-business exchanges do not exploit network effects to stifle competition.

America's antitrust enforcers are working weekends in the pursuit of what they believe are substantial economic benefits for consumers. Are they right? Adam Smith famously noted the tendency of businessmen to take any opportunity to conspire against their customers, but felt that there was little the state could do to stop them. Most other economists were dubious about the effectiveness of antitrust policy until the early 20th century. More recently, the profession has been split over its merits. There is general agreement that competitive markets benefit consumers. The debate concerns whether or not the government is able to keep markets appropriately competitive, and what the costs might be if it intervenes inappropriately. Milton Friedman, for example, started as a supporter of antitrust; but he turned against it in part he thought that the possibility of being the victim of a mistaken antitrust action might deter good businessmen from attempting worthwhile new things.

The trust-busters' biggest difficulty is deciding whether or not a market is (sufficiently) competitive. Traditional legal definitions of market power, which look at the number of significant firms in a market, are viewed with increasing scepticism by economists, who prefer to look at how easy it is for more efficient new firms to enter a market. The Herfindahl-Hirschmann Index, which measures the degree of concentration in an industry by squaring the market shares of firms in the industry and adding up the total, is nowadays dismissed as irrelevant, except as a preliminary screening device. Yet antitrust lawyers still give much weight to it.

Judging the ease and likelihood of new entry inevitably involves speculation, especially about how market structures change over time. For instance, new entry tends to occur because incumbents are earning bigger profits than they need in order to stay in business. It is the sight of excess profit that eventually attracts new competitors.

Those who worry that America's trust-busters are going too far argue that they have used definitions of markets that are far too narrow and static. Many markets under scrutiny are small enough for it to be likely that, if serious monopoly profits were being made, another company would enter. In one recent case, a merger of two of the three biggest baby-food makers was blocked. But Wal-Mart, among others, already makes soft drinks. Can apple sauce be much harder?

Nor are there any obvious large barriers to entrepreneurs opening a supermarket or to banks putting an ATM in a store, for example. Local radio stations face intense competition, not least from rivals delivering via the Internet. The airline industry, subject to numerous antitrust actions, is notable for its meagre profitability, hardly a characteristic typical of the abuse of market power. The case against MasterCard and Visa, which operate in the apparently highly competitive credit-card industry, may repeat a common 1960s error of protecting not competition but a particular competitor, in this case American Express.

Two big oil mergers, Exxon/Mobil and BP/Amoco, have been challenged over the past two years, and allowed to go forward only after numerous concessions were made, including massive divestitures of service stations. Years ago, this may have been important to maintaining

competition. More recently, however, petrol pumps have appeared in front of numerous stores that use the stuff as a draw to sell expensive crisps and sweets to jaded motorists. Another merger, BP Amoco's with Arco, was challenged because both firms had large reserves in Alaska, and BP had used its market power "to maintain higher prices on the west coast by exporting crude oil to the Far East." This conclusion seems to reveal an anti-trade bias and, odder still, to assume that oil prices are not set on a global basis.

The FTC case against CD makers argued that they should not be allowed to demand that retailers include minimum prices for their products when they were mentioned in adverts for their stores. This is a revival of the old attacks on "vertical arrangements" between firms at different stages in the production process. These vertical arrangements, many economists now reckon, are unlikely to be harmful to consumers. In CDs, for example, there is no obvious reason why a manufacturer would want to set minimum prices that reduced its total sales. Nor did anybody stop other (non-advertising) stores from selling the CDs for any price they chose. The FTC also claimed that the vertical arrangement caused consumers harm amounting to $500m, a number that was calculated by the FTC's lawyers but privately disowned by its economists.

The FTC also recently launched the first prosecution in many years under the Robinson-Patman price-discrimination act. After a four-year investigation that ended in March, McCormick, a huge spice company, was found to be selling products in auctions to large grocery chains more cheaply than to other stores. It settled, promising not to discriminate between stores again—which may result, perversely, in higher spice prices for many consumers.

New economy, old rules

In future, however, the biggest question of all is likely to be the role of antitrust in technologically innovative industries. The Microsoft case was crucial in establishing that antitrust had a role to play in the "new economy". But the behaviour of Microsoft in seeking to stifle innovation by rivals was particularly egregious, making it almost more of an old-economy than a new-economy case. In many other instances involving new technologies, a degree of temporary monopoly may be part and parcel of innovation. The treasury secretary, Larry Summers, suggested in a recent speech that the pursuit of monopoly power could become "the central driving thrust of the new economy"—an echo of the arguments made by another economist, Joseph Schumpeter, rather longer ago.

In this model of the "new economy", inefficient monopolies may not survive for long, in contrast to monopolies in the old economy. Because technology such as software requires huge fixed investment up-front, but involves trivial marginal costs, it is highly likely that competition will result in "fragile monopolies" being created, with single companies dominating segments for a time, until they are toppled by rivals. In this world, are antitrust officials able to predict the evolution of market structures better than people working within them? An example of the difficulties occurred just before the Clinton administration took office. As part of a settlement allowing them to merge, Borland and Ashton-Tate were required to cease trying to enforce copyright of the look and feel of their programs. This allowed a new competitor to come in and dominate the market: Microsoft.

However, one argument against this scepticism has been best put by Paul Romer, an economist at Stanford University. He has suggested that the notion that antitrust enforcement is not needed in the new economy rests on the mistaken assumption that technological change is exogenous, that is, independent of an industry's structure. Yet the Microsoft case suggested that a sufficiently powerful incumbent could in some circumstances act as a barrier to innovation. On this basis, Mr Romer concludes that, although it is wise to wait and see if a monopoly proves only temporary before acting, antitrust enforcement may often be more, not less, necessary in the new economy than it was in the old.

An obvious difficulty in proving the effect of antitrust, either way, is that nobody can say how the economy would have developed without it. Certainly, America's markets are generally more competitive than those in countries without antitrust laws, which is striking. On the other hand, points out George Bittlingmayer, an economist at the University of Kansas Business School, periods of aggressive antitrust activity in America, from the attacks on "robber barons" in the 20th century to the 1960s and 1970s, have often been associated with weak economic performance and a lacklustre stockmarket. By contrast, periods of light antitrust activity, such as in the 1920s and 1980s, have been periods of robust growth, innovation and soaring share prices. Still, judging by the stellar performance of America's economy and stockmarket on its watch, the Clinton administration's enthusiastic trust-busting appears to have been benign—at least until recently.

While the extent to which consumers have gained or lost from trust-busting is hard to prove, one group emerges as clear winners from it: the lawyers and economists who make a fortune fighting cases in court. David Boies, the lead attorney in the Microsoft case, has built a big law firm on the back of his performance. Older law firms are rapidly expanding antitrust departments.

Modernise or die

Even supporters of America's antitrust regime think that aspects of it need to be modernised. The first is the 1976 limit requiring any merger in excess of $15m to be filed for approval. That figure is now absurdly low. According to the Business Roundtable, a lobbying group, a merger review typically involves more than 100,000 documents. Congress is considering raising the filing limit to $50m, but in order to capture only the largest 200 deals it would need to raise the figure to $1 billion.

Time is of the essence. Markets often move quickly, as do the inner dynamics of companies. It would help to have a legal fast-track, to minimise uncertainty and to ensure that antitrust cases do not stay so long in the courts that by the time they are concluded the original offence is ancient history. Europe tends to be quicker in reaching antitrust decisions, largely because it keeps them out of the courts. But, as Mr Klein and others have argued, the risk of a divergence of views between trust-busters around the world also points to the need for better co-ordination.

Another idea would be to merge the FTC with the antitrust arm of the DOJ. This would remove incentives for the two agencies to file a lawsuit at the earliest opportunity, to ensure that they do not lose to their rival the right to oversee a particular firm. The last thing the economy needs is a competitive market for antitrust enforcement. To stop firms being tangled in numerous duplicate antitrust cases, Congress could also pass a law, under its right to regulate interstate commerce, tightly restricting the ability of individual states to bring antitrust suits—another area of rapid growth.

Both supporters and opponents alike say that the greatest impact of antitrust is the deals that do not take place. Critics say that the legal costs and business risk associated with antitrust may deter businessmen from trying anything new that might land them in hot water—and that many beneficial activities will not take place as a result. Mr Klein, on the other hand, celebrates those deals that have not occurred because of the regulators. Without antitrust, he could imagine, say, the airline industry consolidating to a single carrier, or Boeing merging with Airbus, along with many other deals that would clearly hurt consumers. There is something to this. But there is also a risk that antitrust officials could over-reach themselves and start interfering too much. Striking the right balance will be a key challenge for the new American president, whoever that is.